Active vs. Passive: We'll Let the Data Guide Us

As steadfast passive investment advisors we are often confronted with many questions surrounding the ever present active vs. passive debate. While we know and expect that the available data and evidence strongly support a passive investment philosophy, it may not always be as apparent to the everyday investor. Knowing this, we thought that it would be a helpful exercise to cover some of the more frequently asked questions surrounding this debate and provide real data to support our position.

The Data –

Every year S&P Global publishes the annual SPIVA® (**S**&P **I**ndices **V**s. **A**ctive) U.S. Scorecard which evaluates whether actively managed funds are able to outperform their corresponding indices over different periods of time (1,3,5,10 & 15-years). Corresponding indices are a hypothetical portfolio of investment holdings which represents a segment of the market and index funds are close approximations of these indices. The key takeaway from the most recent report is no different than that of years past and that is the majority of domestic actively managed funds have underperformed their respective indices over long periods of time. In one (1) year periods you will find that a small number of active managers (31% of Domestic Equity Funds Outperformed for 2018) will be able to beat their respective benchmarks, however the likelihood of those same managers producing consistent results is very small. Over the 5-, 10- and 15-year time periods we see the number of outperforming domestic fund managers reduce significantly to 12%, 15% and 11% respectively (far less than a coin flip!).

Similarly, Morningstar® releases a semiannual report, Morningstar's ® Active/Passive Barometer, that measures the net-of- fees performance of U.S. active funds against their passive peers. What makes this study different is that Morningstar® compared active funds against comparable passive funds (with expenses), not benchmark indices. The most recent study covered about 4,600 unique funds in total and spans over a 10-year period. This study found that just 38% of active domestic funds outperformed their passive peer for the year 2018, which is similar to the results we saw from the SPIVA® report. Additionally, and also similar to the SPIVA® report, you see a number of outperforming active funds reducing significantly over longer periods of time with just 24% of all active funds beating their average passive peer over the last 10 years (ending December 2018).

The S&P Persistence Scorecard, which is released semiannually, tracks the consistency of which active mutual fund managers outperform over consecutive 12-month periods. The Persistence Scorecard uses the University of Chicago's CRSP Survivorship Bias Free Mutual Fund Database to rank available funds in the top-quartile and top-half in performance over non-overlapping three- and five-year periods. The Persistence Scorecard also tracks the amount of funds that are liquidated or consolidated in any 12-month period. The report illustrates that no one can accurately predict which actively managed funds will outperform in a given year, let alone over the longer periods of time.

In conclusion, all three (3) studies provide strong evidence that the probability of active managers consistently earning excess returns is extremely low. To answer the below FAQs, we will use these empirically robust third-party research reports as our basis to measure the success of active vs. passive investment philosophies.

Frequently Asked Questions –

- Don't actively managed funds provide greater protection in down markets?
  Answer: There is no consistent evidence to support the notion that active management provides outperformance or greater downside protection in down markets; in fact, the evidence points to the opposite direction. To support this notion, we look to both the most recent 2018 SPIVA® report (cited above) as well as the 2008 SPIVA® Report. Both reports were published after down years in the market, with the 2008 Report

following the worst bear market of our lives. When analyzing the data in these reports you will find that the results of active management in 2008 match the results we saw in 2018 (and every other down year in between) and that is consistent underperformance relative to their respective benchmarks. Active management has proven to steadily underperform through every phase of the market cycle, though every year we see a very small sub-set of "winners" that temporarily do well before, once again, subsiding into mediocrity.

- Aren't actively managed funds more effective at providing superior returns in inefficient markets?
  Answer: An efficient market is one in which there are a sufficient number of willing buyers and willing sellers exchanging goods. A common theme that is portrayed by active managers is their ability to outperform a given benchmark in emerging markets, because active managers claim emerging markets are not efficient. The data contained in the Year-End 2018 SPIVA® U.S. Scorecard "Report 6: Percentage of International Equity Funds Outperformed by Benchmarks" (pg.17) illustrates that all geographic regions enjoy efficient markets – in other words, active managers in emerging markets equities have not consistently demonstrated an ability to outperform the market. This is not to say that no active managers will do well in some geographies over some periods of time; however, as a group, we think it's reasonable to expect active managers will consistently underperform benchmarks because markets are generally efficient and they function properly.

- Can't some of the really good managers outperform on a consistent basis (persistency)?
  Answer: According to the September 2018 S&P Persistence Scorecard, relatively few funds can consistently stay as top performers in their respective asset class. Of the relatively few funds that outperform, few can do so repeatedly. Across all funds, the incidence of 3 years or 5 years of consecutive top half performance is generally less than that expected by random chance. There is little evidence that managers who have outperformed can predictably continue to outperform. If managers cannot consistently outperform, then there is no use trying to identify them in advance. Manager selection and the hiring or firing of managers is a futile exercise. The question then becomes how do we know which funds will outperform in any given year? The answer is, we don't know. Even if we did, based on the data, it is not very probable that the same fund will consistently be a top performer. Thus, there will likely be adverse tax consequences and load fees from changing funds year to year.

Our advice: decide on an asset allocation appropriate for your risk tolerance, accept the long-term positive returns that the market provides, stay disciplined throughout all the cycles (ups and downs) of the market and save more of your money for yourself instead of spending it on fund expenses and taxes.

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Additional Resources:

SPIVA® Around the World – World map showing the percentage of active funds outperformed by benchmarks over 1-,3-, and 5-year periods.

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